Attorney-Client Partnerships With a Straight Face

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Outside personal physical injury and employment lawsuits, many plaintiffs have difficulty deducting attorney fees and face miscellaneous itemized deduction limitations and alternative minimum tax. The author examines the attorney-client partnership that the Supreme Court failed to address in *Banks*. He concludes that the threshold for a tax partnership is low and that some decisions imposing partnership treatment may help taxpayers.

For decades, taxpayers receiving litigation recoveries have struggled with the tax treatment of attorney fees. If a plaintiff receives a recovery and simultaneously pays fees to his contingent fee lawyer, is the client taxed on the net or the gross amount (followed by a miscellaneous itemized deduction)? Until the Supreme Court decided *Commissioner v. Banks*[1] in 2005, there was a well-publicized split in the circuits.[2] That split caused all manner of gyrations, with some taxpayers even moving to different states in a kind of tax-driven forum shopping.

Banks held that the client has gross income on the entire recovery even if the contingent fee lawyer is paid directly by the defendant and the client receives only a net check. Controversially, however, the Supreme Court announced its holding as a general rule, explicitly sidestepping various theories that might change this result and leaving room for exceptions. The Court said it was not considering various theories urged on it by a blizzard of amicus briefs. One of these theories was that lawyer and client could be viewed as partners, so that each could be taxed only on its share of the partnership's spoils.

Some even thought Congress obviated *Banks*. Several months before the Supreme Court's opinion, Congress amended section 62 to allow plaintiffs an above-the-line deduction for attorney fees paid to pursue unlawful discrimination claims and specific claims against the government.[3] If applicable retroactively (which the amendment was not), it would have mooted *Banaitis v. Commissioner*[4] and *Banks v. Commissioner*,[5] the two cases consolidated before the Supreme Court.

However, if a plaintiff does not qualify for the statutory above-the-line deduction and the legal fees were not paid in pursuing a trade or business, deducting the fees can be a big problem. Miscellaneous itemized deductions are a far cry from netting or a deduction above the line.[6]

Given the generally unyielding rule announced in *Banks*, there are few options for plaintiffs who receive taxable recoveries under a contingent fee agreement. Of all the topics the Supreme Court refused to address in *Banks*, whether a partnership could exist between lawyer and client seems the most controversial.

Partnership Theory

Not a taxpaying entity, a partnership allocates income and loss to its partners who themselves pay

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[1] 543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*.

[2] *See* Robert W. Wood, ''Supreme Court Attorney Fees Decision Leaves Much Unresolved,'' *Tax Notes*, Feb. 14, 2005, p. 792, *Doc 2005-2351*, or *2005 TNT 24-67*; Wood, ''Will the IRS Pursue Attorney Fees Post-*Banks*?'' *Tax Notes*, July 18, 2005, p. 319, *Doc 2005-14789*, or *2005 TNT 133-36*; and Wood, ''Contingent Attorney Fees in the Post-*Banks* Era,'' *Tax Notes*, Feb. 6, 2006, p. 663, *Doc 2006-1793*, or *2006 TNT 25-77*.

[3] Section 62(a)(20) and (e), added by the American Jobs Creation Act of 2004, 118 Stat. 1418.

[4] 340 F.3d 1074 (9th Cir. 2003), *Doc 2003-19359*, *2003 TNT 167-5*.

[5] 345 F.3d 373 (6th Cir. 2003), *Doc 2003-21492*, *2003 TNT 190-11*.

[6] Section 67(a).

tax. If an attorney-client relationship can be a partnership for federal income tax purposes, any recovery should be allocated to the partners in accordance with their respective interests in the partnership. Some lawyers suggest that ethics rules prevent partnering with clients. Yet a valid partnership under state law is not a prerequisite to a partnership for federal income tax purposes.

The code defines a partnership as a ''syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on . . . which is not . . . a trust or estate or a corporation.''[7]

A similar definition applies within subchapter K.[8] Both definitions are expansive, suggesting partnership classification as a catchall for anything that is not a trust, estate, or corporation.[9] The check-the-box regulations make it clear that federal tax law determines whether a partnership exists for tax purposes, and it does not depend on whether the partnership is recognized under local law.[10]

In determining what constitutes a partnership for tax purposes, courts also examine the parties' intent. In *Commissioner v. Culbertson*,[11] the Supreme Court listed factors bearing on whether the parties intended to create a partnership:

- the agreement;
- the conduct of the parties in execution of its provisions;
- the statements of the parties;
- the testimony of disinterested persons;
- the relationship of the parties;
- the abilities and capital contributions of the parties;
- the actual control of income and the purposes for which it is used; and
- any other facts shedding light on the parties' true intent.[12]

Individuals coming together to make and divide profits is the essence of a partnership. The mere sharing of expenses does not create one.[13] However, carrying on a financial operation or venture and dividing the profits *can* be enough.[14] Mere co-ownership of property does not make a partnership,[15] but co-owners who provide services directly or through an agent does.[16] Contractual arrangements to divide profits can also qualify.[17]

When there are two or more parties involved in a financial arrangement and the type of entity is not otherwise clear, a partnership results.[18] An eligible domestic business entity with two or more members not classified as a corporation is a partnership unless it elects to be treated as a corporation.[19]

Of course, a partnership should file a partnership return.[20] The Form 1065 must be signed by a general partner (or managing member of a limited liability company).[21] Some attorneys may not want to file a partnership return. Yet lawyer and client could include their shares of partnership income, deductions, and credits on their personal returns.

Failure to file a partnership return subjects a partnership to penalties but does not prevent the existence of a partnership. The penalties are not onerous: $85 times the number of partners per month, not to exceed 12 months.[22] A willful failure to file can incur greater penalties,[23] but no penalty is imposed if the partnership can show the failure was for reasonable cause.[24] Many small partnerships are presumed to have reasonable cause,[25] which should cover many attorneys and clients. Even if that

[7]Section 7701(a)(2).

[8]Section 761(a).

[9]William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 3.02[1] (4th ed. 2007).

[10]Reg. section 301.7701-1(a)(1).

[11]337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946).

[12]*Culbertson*, 337 U.S. 733; *see also Allum v. Commissioner*, T.C. Memo. 2005-177, *Doc 2005-15466, 2005 TNT 139-9*, *aff'd*, 231 F. Appx. 550 (9th Cir. 2007), *Doc 2007-10844, 2007 TNT 86-16* (which cites the partnership factors in *Culbertson*).

[13]Reg. section 301.7701-1(a)(2).

[14]*Id.*

[15]*Id.*

[16]*Id.*

[17]*See, e.g.*, *Meehan v. Valentine*, 145 U.S. 611 (1892). (A Supreme Court case over 100 years old, yet which still appears to be good law, that commented that ''it appears to be settled that the written contract entitling Perry to a share of the net profits, at least, makes out a prima facie case of partnership.'')

[18]Reg. section 301.7701-3(a) and (b)(1).

[19]Reg. section 301.7701-3(a) and (b)(1)(i); *see also People Place Auto Hand Carwash, LLC v. Commissioner*, 126 T.C. 359, 364 (2006), *Doc 2006-11521, 2006 TNT 115-15*.

[20]Section 6031; reg. section 1.6031(a)-1(a); ''2007 Instructions for Form 1065,'' *available at* http://www.irs.gov.

[21]*See* ''2007 Instructions for Form 1065,'' *available at* http://www.irs.gov.

[22]Section 6698(a), (b), and (c).

[23]Section 7203.

[24]Section 6698(a).

[25]A small partnership is presumed to have reasonable cause if: (1) each partner has fully reported its share of income, deductions, and credits on his timely filed income tax return; (2) the partnership consists of 10 or fewer partners that are either individuals (other than nonresident aliens), a C corporation, or an estate of a deceased partner; and (3) each partner's interest in the partnership items corresponds with its proportionate share of all other items. Rev. Proc. 84-35, 1984-1 C.B. 509; SCA 200135029 (Aug. 1, 2001), *Doc 2001-22929, 2001 TNT 171-60*; Jerold A. Friedland, *Tax Planning for Partners, Partnerships, and LLCs*, section 15.05 (2008); Alan J. Tarr and Pamela Jensen Drucker, *Civil Tax Penalties* at A-10 (BNA Tax Management Portfolios 2005).

exemption does not cover a particular case, one may still be able to show reasonable cause.[26]

State Laws and State Bars

Just as state law does not dictate whether a partnership is created for federal tax purposes, state law rules of conduct for attorneys cannot, either.[27] Federal tax law trumps state law, including codes of professional conduct.[28] Courts may use those rules to void agreements between attorneys and clients.[29] However, if the client asks the attorney to recast the lawyer's contingent fee agreement as a partnership agreement, the client has not been damaged.

Attorneys often assume that a lawyer-client partnership is flatly prohibited under state law. However, many state bar rules contain no outright prohibition on lawyer-client partnerships, even for purposes of state law. The restrictions are generally designed to prevent lawyers from forming *other* businesses with clients, not a venture pursuing the legal matter on which they are working. Some say the rules prevent partnerships in which the client might be practicing law. However, a plaintiff cannot be viewed as practicing law regarding his *own* claim, because plaintiffs can represent themselves in *pro per*.

Attorneys and Clients as Partners

In the classic marketed tax opinion of yesteryear (before the check-the-box regime), tax professionals spent considerable time concluding that the vehicle in question was likely to be a partnership for federal income tax purposes, then turning to what were often perfunctory tax issues thereafter. However, the merits of the attorney-client partnership argument remains largely untested. In *Bagley v. Commissioner*[30] and *Allum v. Commissioner*,[31] the taxpayers argued the presence of a partnership, but neither presented any significant evidence that he had intended to create a partnership with his attorney. In each case, the court applied the *Culbertson* intent factors and found that no partnership was created.

Who wants partnership tax treatment varies. The authorities seem to mostly involve taxpayers asserting the existence of an attorney-client partnership. We might refer to these assertions as using partnerships as a shield. Yet in some cases, the IRS has attempted to use a partnership as a sword to seek additional revenue.

[26]Rev. Proc. 84-35, section 3.03.

[27]*See ABA Model Rules of Professional Conduct*, preamble.

[28]*Id.*

[29]*See, e.g.*, *Grausz v. Farber*, 2002 Cal. App. Unpub. LEXIS 6091 (Cal. App. 1st Dist. 2002).

[30]121 F.3d 393 (8th Cir. 1997), *Doc 97-23130, 97 TNT 153-8*, *aff'g* 105 T.C. 396 (1995), *Doc 95-11034, 95 TNT 241-12*.

[31]T.C. Memo. 2005-177, *Doc 2005-15466, 2005 TNT 139-9*.

Down on the Farm

Recently, in *Holdner v. Commissioner*,[32] the Tax Court found a farm operated by a father and son to be a partnership for federal income tax purposes. Although this case did not involve attorney fees, its reasoning and result may help litigants faced with making the partnership argument. It and similar cases in which the IRS (not the taxpayer) is advocating partnership tax treatment may prove relevant to the attorney fee issue.

Starting in 1977, William and Randal Holdner, father and son, ran Holdner Farms. Although they had no written agreement, they orally agreed Randal would be entitled to half of the gross proceeds from cattle sales and an equal equity interest in Holdner Farms. The Holdners purchased additional property and held it as tenants in common.

From its 1977 roots, Holdner Farms eventually grew into a profitable cattle farming and logging operation. From 2004 through 2006, Randal managed day-to-day operations, often working 16- to 18-hour days. William, a practicing accountant, was primarily responsible for finances and accounting. Each had signature authority with the bank.

The pair purchased an insurance policy for Holdner Farms that disclosed the form of the business as a partnership. In 2003, they registered it as a partnership with the state of Oregon, renewing that registration in 2004 and 2006. Rather than annually filing a Form 1065, however, father and son each reported half of the gross income for 2004, 2005, and 2006 on their respective individual schedules F and D. Nevertheless, they did not split expenses equally.

In fact, William (the accountant father) deducted most of the expenses on his Schedule F. On audit, the IRS issued separate notices of deficiency determining that Holdner Farms was a partnership and that the Holdners were equal partners. The notice to William sought accuracy-related penalties for deducting all the expenses. The Holdners argued that their enterprise was a joint venture between two proprietorships. William asserted that the allocation of expenses was related to his investments in Holdner Farms and to his agreements with his son regarding specific expenses.

Sword or Shield?

In some ways, of course, this is a silly case. It is unclear why father and son thought they could divvy up expenses in that way. Perhaps the accountant father wanted to deduct all the expenses and thought a partnership allocation to him would not have substantial economic effect. We do not know.

[32]T.C. Memo. 2010-175, *Doc 2010-17437, 2010 TNT 150-16*.

We do know that the Holdners were seeking to deny partnership treatment, not embrace it. Yet even in the absence of partnership tax returns, this looked and smelled like a partnership. Both father and son contributed capital and labor. Holdner Farms had conducted business since 1977. It was substantially more than a mere co-ownership of property or a means of sharing expenses.

In fact, the court found an overwhelming record that Holdner Farms was a business activity jointly owned by father and son. But here the Tax Court hedged its bets in ways that might be helpful to a plaintiff and attorney seeking to have their arrangement recognized as a partnership for tax purposes. The Tax Court noted that even if Holdner Farms was a joint venture rather than a true partnership, the joint venture would create a separate entity for federal income tax purposes. After all, father and son carried on a farming business.[33]

Further, as a separate domestic entity with at least two members, it would be treated as a partnership for federal income tax purposes under the check-the-box rules for classifying entities. Plainly, the Holdners failed to elect for the enterprise to be taxed as a corporation.[34] The Tax Court found seven of the eight factors from its test for partnership status[35] supported viewing the arrangement between father and son Holdner as a partnership because:

- they agreed to split income, and they followed their agreement;
- they both contributed capital and services;
- they had equal access to and control over bank accounts;
- they shared a mutual proprietary interest in the farm;
- the name "Holdner Farms," while ambiguous, suggested an enterprise that was not limited to one family member;
- although they failed to file Form 1065 returns, they represented to their insurer and to the state of Oregon that their farm was a partnership;
- they maintained a separate bank account for the farm and kept meticulous records; and
- they exercised mutual control over and responsibility for the farm.

Documenting the Attorney-Client Relationship

Most attorney-client arrangements won't include this many helpful features without effort. But the standards for a partnership for federal income tax purposes are pretty low.

Intent is understandably important. In rejecting the taxpayer's de facto partnership theory in *Allum*, the Tax Court noted that the taxpayer did not view his attorney "as a co-owner of his legal claims, but rather, as a legal representative receiving compensation for his services."[36] Still, a general "we intend to create a partnership" provision alone might be enough.

The taxpayer in *Allum* had nothing going for him, not even an expression of intent. One could easily make a legal fee agreement look like a partnership agreement or a partnership agreement look like a fee agreement. Concern about potential ethical violations may prompt a savings clause that "notwithstanding anything herein to the contrary, this agreement shall be interpreted as a partnership between lawyer and client only to the extent permitted by law."

Of course, there is much more that could be done. Some practitioners may want the plaintiff to contribute his claim to the partnership. The client, attorney, or both could contribute funds to the partnership to cover the costs to prosecute the claim. Indeed, that will happen whether or not they *call* it a partnership.

The income or loss would flow through to the partners. If the partnership is formed before the claim is filed, the partnership might itself be a plaintiff. Otherwise, the partnership may simply own all or a portion of the claim the plaintiff contributed to it, although the case proceeds solely in the plaintiff's name. Such an arrangement should satisfy the *Culbertson*[37] intent factors, the code's partnership definition, and the check-the-box regulations.

Minimum Documentation?

According to the Tax Court in *Allum*, a standard fee agreement alone will generally not qualify as a partnership for purposes of federal income tax law.[38] That is not surprising, but even on *Allum*'s rather obvious facts, the court said "generally" (not unlike the Supreme Court in *Banks*). There was a complete lack of partnership criteria or intent on *Allum*'s facts.

Names matter. Yet it is worth examining whether one can have a partnership for federal income tax purposes even though the document signed by lawyer and client is a standard fee agreement and entitled a "Fee Agreement." The father and son in *Holdner* did not even have a written agreement yet were deemed partners. The title of the agreement

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[33]*See* reg. section 301.7701-1(a)(2).
[34]*See* reg. section 301.7701-3(b)(1)(i).
[35]*See Luna v. Commissioner*, 42 T.C. 1067 (1964).
[36]*Allum*, *supra* note 31.
[37]*Supra* note 11.
[38]*Allum*, *supra* note 31.

alone should not control whether the agreement and the parties' conduct indicate they *intended* to create a partnership. Despite the title, it may be enough if the contingent fee agreement includes language that "the parties intend this Agreement to constitute a partnership for federal income tax purposes."

Should a check-the-box form be filed? The regulations permit contractual arrangements to be cast as partnerships, and there seems little downside to filing such a form. Perhaps the attorney-client partnership should obtain an employer identification number (EIN) and file partnership tax returns, too, but a partnership may be recognized without them.

In *S.O. Clagget, Liquidating Trustee for S.O. Claggett, Inc.*,[39] the Tax Court addressed whether the agreement effected a contractual relationship or a partnership. Despite a lack of partnership tax returns, it found a partnership. In *Allum*, the Tax Court analyzed the taxpayers' intent to create a partnership under the *Culbertson* factors.[40] As in *Holdner*, it cited *Luna v. Commissioner*,[41] for additional partnership criteria:

- whether each party was a principal and coproprietor;
- whether one party was the agent or employee of the other, receiving compensation for services in the form of a percentage of income (which would weigh against a partnership);
- whether the parties filed federal partnership returns or otherwise represented that they were joint ventures; and
- whether the parties exercised mutual control and responsibilities over the enterprise.[42]

Whether the parties intend a partnership "is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions."[43] In *Allum*, not one single point was satisfied, leading to an easy conclusion there was simply no partnership. The more steps lawyer and client take, the more secure a plaintiff may feel. Yet one need not satisfy all those criteria, and none is conclusive.

[39]44 T.C. 503 (1965).

[40]*Allum*, *supra* note 31; *see also Culbertson*, 307 U.S. at 742.

[41]*See Luna*, 42 T.C. 1067.

[42]*Allum*, *supra* note 31, *33 (citing *Luna*, 42 T.C. at 1077-1078).

[43]*Commissioner v. Tower*, 66 S. Ct. 532, 536 (1946) (citing *Drennen v. London Assurance Co.*, 113 U.S. 51, 56 (1885)); *see also Estate of Smith v. Commissioner*, 313 F.2d 724, 729 (8th Cir. 1963); *Luna*, 42 T.C. at 1078.

Conclusion

The Supreme Court in *Banks* failed to consider whether an attorney-client partnership avoids gross income to the client on the attorney's share. Given the language of the code, the case law, and the check-the-box regulations, a little planning may make an attorney-client partnership position credible. Intent and timing are important, but a few items from this menu should arguably be enough:

- executing a written agreement that uses at least some "partnership" nomenclature;
- keeping books that reflect the partnership's allocations of contributions and distributions;
- filing a statement of partnership with the county recorder, secretary of state, or other office under state law;
- filing a "doing business as" form;
- obtaining an EIN;
- filing a check-the-box form; and
- filing partnership tax returns.

The IRS and the courts will eventually have to address just how much is enough to allow lawyer and client to report only their share of the recovery. Although taking most of these actions should surely solidify partnership tax treatment, the hurdle to making the argument appears to be low. The fact that the courts will impose partnership treatment, as the Tax Court did in *Holdner*, may help attorneys and their clients hoist the Service by its own petard.

Yet the attorney-client partnership is not the only argument clients will use against *Banks.* How much lawyer and client are willing to do may depend on whether they can also argue that the fee is a statutory fee outside *Banks*'s general rule, is deductible above-the-line deduction under section 62, arises out of a trade or business (to be netted on Schedule C), or is capital (to be netted on Schedule D). All those issues are likely to go into the mix in assessing the attorney-client partnership.